

franchises is a function of anticipated monopoly profits.<sup>51</sup> That is why cable systems sell at three or more times their replacement cost.<sup>52</sup>

Allowing cable operators to include such monopoly premiums in their ratebase would yield cable rates calculated to produce monopoly profits.<sup>53</sup> That would lock in the very exercise of market power that the 1992 Act was intended to eradicate, and it would provide an entirely unjustified competitive advantage to cable in competition with telcos. Furthermore, cable consumers should not have to bear higher rates merely because a cable operator has paid a premium for existing cable properties without adding any benefit to the service provided to consumers.<sup>54</sup> Since excess acquisition costs do not reflect a contribution of capital to the regulated public service, allowing them to enter into the operator's ratebase calculation would force cable's ratepayers to finance

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<sup>51</sup> See, e.g., S. Rep. No. 92, 102d Cong., 1st Sess. 8-10 (1991). The Senate Committee relied in part on statements by a major cable operator acknowledging that "[t]he value of a cable franchise follows from the protection from the competition that it provides the holder. Since the holder of the franchise will have a monopoly, the prospective cable operator would be able to generate a cash flow that would result in a supranormal return . . . ." *Id.* at 9 (emphasis in original). The Report also quoted the then-Chairman of the FCC, who testified that the average per-subscriber acquisition value of monopoly cable systems was about five times as high as the investment cost and that this is "the premium the market places on having that monopoly position." *Id.*

<sup>52</sup> See Vander Weide Aff. ¶ 31.

<sup>53</sup> *Id.*

<sup>54</sup> *Id.* ¶ 32.

acquisition premiums instead of paying for the services they receive.<sup>55</sup>

Nor should excess acquisition costs be amortizable as an annual expense.<sup>56</sup> Since acquisition premiums do not reflect expenditures that enhance cable service, there is no more justification for saddling cable ratepayers with such costs in the form of expenses than in the form of a higher ratebase.<sup>57</sup> Likewise, cable should not be permitted to recover through regulated rates any interest expense attributable to debt that is incurred to finance the payment of monopoly acquisition premiums.

This does not mean that cable cannot recover its full acquisition costs. It means only that the excess portion of those costs may not be recovered through regulated cable rates.

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<sup>55</sup> See Bonbright, Danielson, and Kamerschen, Principles of Public Utility Rates 239-40 (1988): "[I]nvestors are not compensated for buying utility enterprises from their previous owners any more than they are compensated for the prices at which they may have bought public utility securities on the stock market. Instead, they are compensated only for devoting capital to the public service." The only capital so devoted is the original owner's actual investment. The acquiring company must therefore stand in the shoes of the selling company. *Id.* Moreover, a rule permitting recovery of excess acquisition costs would place the owner "who does not sell . . . at a disadvantage compared with one who does." Niagara Falls Power Co. v. FPC, 137 F.2d 787, 793 (2d Cir. 1943) (L. Hand, J.).

<sup>56</sup> See NPRM ¶ 41.

<sup>57</sup> Vander Weide Aff. ¶ 33.

The costs may still be recovered from cable's various other services.<sup>58</sup>

- c. Cable's rate of return should be established according to the same principles applicable to telephone companies.

The Commission should compute cable's allowable rate of return by using the principles it applies to telephone companies. Specifically, as Dr. Vander Weide explains in his accompanying affidavit, the Commission should use the "capital attraction" standard, under which each source of capital is allowed to earn a rate of return commensurate with its perceived risk to investors.<sup>59</sup> Like telcos, cable should be allowed to recover its average cost of capital as determined by its cost of debt, its cost of equity, and its capital structure.<sup>60</sup>

The capital attraction standard properly balances the interests of both cable operators and ratepayers. If the rate of return were set above the cost of capital, ratepayers would pay more than is required to induce a cable operator to provide quality service and expand its network. If the rate of return were set below the cost of capital, cable operations would be

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<sup>58</sup> The Commission should treat cable plant under construction, abandoned plant, excess capacity, and working capital in the same manner as it does for telcos. Nothing in the 1992 Act warrants special rules for cable.

<sup>59</sup> See Vander Weide Aff. ¶ 7.

<sup>60</sup> Id. ¶¶ 7, 16.

an unattractive investment and it would be difficult for cable to expand its infrastructure.<sup>61</sup>

In particular, the Commission should compute the average cost of capital for cable by referring to cable's actual cost of debt and actual capital structure. Because the actual figures on debt cost and capital structure for the largest cable firms are widely available and reasonably representative of the cable industry as a whole, there is no need for the Commission to resort to surrogates.<sup>62</sup> As Dr. Vander Weide has demonstrated in his affidavit, cable's actual cost of debt is approximately 7.8%, and its actual capital structure (excluding its large accumulated losses from the definition of equity) is approximately 86% debt and 14% equity.<sup>63</sup>

Cable's actual cost of equity is difficult to estimate because most companies are closely held, are part of widely diversified operations, or pay no dividends.<sup>64</sup> Consistent with the governing legal test, the Commission should therefore determine cable's cost of equity by using a surrogate with "corresponding risks."<sup>65</sup> As long as the Commission uses cable's actual capital structure and cost of debt, an

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<sup>61</sup> Id. ¶ 8.

<sup>62</sup> Id. ¶ 9.

<sup>63</sup> Id. ¶ 10.

<sup>64</sup> Id. ¶ 11.

<sup>65</sup> Hope Natural Gas, 320 U.S. at 603; accord Bluefield Water Works & Improvement Co. v. Public Service Comm'n, 262 U.S. 679, 692-93 (1923).

appropriate surrogate would be the third quartile of the S&P Industrials (formerly known as the S&P 400).<sup>66</sup> Although these firms have slightly greater business risk than the average cable operator, they are not as highly leveraged as the typical cable company.<sup>67</sup> Considering both business and financial risk, therefore, it is reasonable to assume that an equity investment in the third quartile of the S&P Industrials has roughly the same risk as an investment in the cable industry.<sup>68</sup> The average cost of equity for the third quartile of the S&P Industrials is 15.11%.<sup>69</sup>

In contrast, basing cable's rate of return on the S&P Industrials' average cost of debt, cost of equity, and capital structure as the Commission proposes would lead to exorbitant returns on equity for cable given its actual debt costs and capital structure. Average S&P Industrials figures would give cable a return on equity of nearly 37%<sup>70</sup> -- clearly more than Congress could have intended. Similar distortions would result if the Commission were to impute a 50/50 debt/equity ratio to cable instead of using the industry's actual capital structure.

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<sup>66</sup> Vander Weide Aff. ¶¶ 11, 17-20.

<sup>67</sup> Id. ¶ 20.

<sup>68</sup> Id.

<sup>69</sup> Id. This is an appropriate surrogate only if the Commission uses cable's actual capital structure. If the Commission uses a different capital structure, such as its proposed 50/50 debt/equity ratio, cable's cost of equity should be set no higher than the average of the first quartile of the S&P Industrials, currently 11.8%. Id. ¶ 21.

<sup>70</sup> Id. ¶ 14.

That approach would produce a return on equity for cable of more than 32%.<sup>71</sup>

The Commission should not be concerned if applying these principles in a neutral manner yields an overall rate of return for cable that is no higher than the regulated return for telephone companies. At least with respect to basic-tier service, Congress did not expect cable's rate of return to rise to the level of that for telcos.<sup>72</sup> Nor should the Commission reject the capital attraction standard merely because it may result in regulated returns for cable that are outside the 10% to 14% range.<sup>73</sup> Congress intended for cable operators to earn a fair return; it did not legislate any particular level or range. If cable's average cost of capital -- given its debt costs and high leverage -- falls below 10%, nothing in the statute requires or even permits the Commission to raise cable's return above that level.

d. Cable should be required to restate its financial results for regulatory purposes.

Cable's financial reports must be restated to provide a proper measure of its financial performance for regulatory purposes. Although many cable companies currently report little or no net income, their figures are distorted by rapid depreciation of assets, amortization of excess acquisition

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<sup>71</sup> Id. § 15.

<sup>72</sup> See House Report at 83.

<sup>73</sup> See NPRM at § 21. Using the same principles that apply to telcos, Dr. Vander Weide estimates that cable's fair rate of return is approximately 8.83%. Vander Weide Aff. § 23.

costs, and the high interest expenses attributable to their heavy reliance on debt financing.<sup>74</sup> Like telephone companies, cable operators should be required to restate their financial results to eliminate any such distortions and to provide a proper foundation for determining allowable revenues from regulated services.

Once a cable operator's financial reports have been restated, its allowable revenues from regulated cable service can be determined by multiplying the operator's regulated rate base by its permissible rate of return and then adding allowable expenses.<sup>75</sup> Comparing that figure to the operator's actual revenues will reveal whether the regulated rates should be adjusted in either direction and by how much.

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<sup>74</sup> Id. ¶ 39.

<sup>75</sup> Id. ¶ 42.

## **CONCLUSION**

To fulfill the Congressional purpose of encouraging competition for cable from alternative video technologies, and to allow market forces rather than artificial regulatory advantages to dictate the competitive outcome between the converging cable and telephone industries, the Commission must frame its cost-of-service structure for cable in a manner that closely parallels the rules historically applied to telephone companies.

Respectfully submitted,



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August 25, 1993

**Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554**

In the Matter of	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	MM Docket No. 93-215
Protection and Competition Act	)	
of 1992	)	

**AFFIDAVIT OF JAMES H. VANDER WEIDE**

**I. INTRODUCTION**

1. I have been asked by Bell Atlantic, NYNEX, and the Pacific Companies to respond to issues raised in the Federal Communication Commission's Notice of Proposed Rulemaking (NPRM) in MM Docket No. 93-215 released July 16, 1993. As part of my response, I will discuss the Commission's proposals regarding: 1) the fair rate of return; 2) the rate base and allowed expenses; and 3) measures of financial performance for cable operators who are seeking to justify rates above those determined by the Commission's benchmarks and price caps.

2. I am Research Professor of Finance and Economics at the Fuqua School of Business, Duke University. In addition to my teaching and executive education activities, I have written research papers on such topics as portfolio management, the cost of capital, capital budgeting, the effect of regulation on

the performance of public utilities, and cash management. My articles have been published in *American Economic Review*, *Financial Management*, *Journal of Finance*, *Journal of Financial and Quantitative Analysis*, *Journal of Bank Research*, *Journal of Accounting Research*, *Journal of Cash Management*, *Management Science*, *The Journal of Portfolio Management*, *Atlantic Economic Journal*, *Journal of Economics and Business*, and *Computers and Operations Research*. I have written a book titled *Managing Corporate Liquidity: An Introduction to Working Capital Management*, and a chapter for *The Handbook of Modern Finance*, "Financial Management in the Short Run." I graduated from Cornell University with a Bachelor's Degree in Economics and earned a Ph.D. in Finance at Northwestern University.

3. As an expert on financial and economic theory, I have submitted testimony and/or testified on the cost of capital and other regulatory issues before the Federal Communications Commission, the Federal Energy Regulatory Commission, the National Telecommunications and Information Administration, the U.S. Congress, the insurance commissions of five states, and the public service commissions of 29 states and the District of Columbia. Before the FCC, I have prepared affidavits in response to the Commission's Notices of Proposed Rulemaking in CC Docket 84-800 Phases I, II, and III, CC Docket 87-463 Phases I and II, and CC Docket 89-624 Phases I and II. Most of my appearances involve testimony on the cost of capital and fair rate of return.

4. A brief review of my academic background, as well as my qualifications and experience as an expert witness on financial and economic theory, is contained in Appendix 1 to this affidavit.

## **II. RATE OF RETURN**

- A. The Commission should apply the same regulatory principles and methodologies to set the cable companies' fair rate of return as they apply to the telecommunications companies.**

5. In setting the fair rate of return for the cable industry, the Commission must recognize that the cable and telecommunications industries are rapidly converging, and that companies in these two industries compete for funds in the capital markets. Large cable companies are developing plans to offer telecommunications services to residential and business customers over their own networks, which provide access to millions of customers. The acquisition of Teleport Inc. by Cox Enterprises and Tele-Communications, Inc.; Time Warner's recent announcement of its plan, partially financed by U. S. West's \$2.5 billion investment in Time Warner, to build an electronic superhighway throughout its service territory; and Tele-Communications, Inc.'s announcement that it will invest \$2 billion over the next several years to install fiber in its network so that it can be the multimedia carrier of choice for its customers, are three examples of the cable companies' decisions to enter the

telecommunications industry. In a similar manner, telecommunications companies are making plans to offer cable-like services over their telephone networks.

6. Given the rapid convergence of the cable and telecommunications industries, it is essential that cable operators be held to the same regulatory standards as the telecommunications industry. If one side were to gain an advantage through the regulatory process, the benefits of competition could be lost. In order for a competitive cable/telecommunications marketplace to develop, the Commission should apply the same regulatory principles and methodologies to set the cable companies' fair rate of return as they apply to the telecommunications companies.

- B. The Commission should base the cable industry's fair rate of return on the cable industry's cost of debt, cost of equity, and capital structure.

7. The governing economic principle for setting the cable operators' fair rate of return is that each source of capital—i.e., debt, preferred stock, and common equity—should be allowed to earn a rate of return that is commensurate with its perceived risk to investors. This principle, known as the capital attraction standard, dictates that cable operators should be allowed to recover their average cost of capital as determined by: 1) their cost of debt; 2)

their cost of equity; and 3) their capital structure. A surrogate is required to implement the capital attraction standard only for those components of the cable industry's cost of capital that are not measurable from cable industry data.

8. The Commission seeks comments on how it can balance the interests of ratepayers and cable companies. The capital attraction standard provides the proper balancing of ratepayers' and cable operators' interests. If the rate of return is set above the cost of capital, ratepayers would pay more than is required to induce a cable television company to provide quality service and expand its network. If the rate of return is set below the cost of capital, then no investor would want to invest in cable operators, and no infrastructure expansion would be possible. For purposes of setting initial reasonable rates in a cost of service showing, the cost of capital is itself the level that balances ratepayers' and operators' interests; no further adjustments need be made.

9. Of the three elements required to estimate the cable industry's average cost of capital—its cost of debt, cost of equity, and average capital structure—two are readily available from cable industry data. For the cable industry's cost of debt and capital structure, the Commission should use financial data relating to a group of the industry's largest firms. In the telecommunications industry, the Commission has chosen to use a group of the industry's largest firms to represent the financial position of the industry as a

whole. The reasons for using a group of the largest firms are similar in this case: 1) a high percentage of subscribers are served by the largest multiple system operators; 2) many of the remaining systems are small operations for which extensive filing requirements would be burdensome; and 3) many cable systems are privately held and no financial data is readily available. In addition, some cable operators are widely diversified, and it is not possible to associate a specific capital structure with each line of business. These companies should not be used in determining the industry's financial profile.

10. The following group of six cable operators are among the largest U. S. cable operators for which financial data is available on CompuStat: Adelphia Communications, Cablevision Industries, Cablevision Systems, Comcast Corporation, Continental Cablevision, and Tele-Communications, Inc. These companies accounted for approximately 30 percent of total U. S. cable subscribers in 1992. Using the CompuStat data, I have determined that these companies have an embedded cost of debt equal to approximately 7.80 percent (calculated by dividing interest expense by the book value of debt). Their debt ratio  $[\text{debt} / (\text{debt} + \text{equity})]$  is 113.77 percent when the cable operators' large accumulated losses are included in the definition of equity, or is 86.01 percent when accumulated losses are not included in equity. The use of the 86.01 percent debt ratio is recommended for the following reasons: 1) it is not possible to calculate an average cost of capital when the percent debt exceeds

100 percent; and 2) the 86 percent debt ratio is more likely to approximate the industry's long-run target capital structure.

11. The cost of equity is the only element that is difficult to estimate from cable industry data because many cable companies are closely held, widely diversified, and pay no dividends. As a result, it is necessary to use a surrogate to establish the appropriate rate of return on equity for the cable industry. The governing principle in setting an appropriate rate of return on equity is clear: the rate of return on equity for cable should be set "commensurate with returns on equity investments in other enterprises having corresponding risks" (Federal Power Comm'n v. Hope Natural Gas Co., 320 U. S. 591 (1944) at 603). Thus, to estimate the cable industry's cost of equity, the Commission must identify a surrogate firm or group of firms having equity risks similar to an equity investment in the cable industry.

- C. The Commission's proposal to base the cable industry's fair rate of return on the S&P Industrials' average cost of capital would produce excessively high rates of return on equity for cable operators.

12. Rather than use cable industry specific data, the Commission proposes to base the overall rate of return for cable operators on an estimate of the average cost of capital of a surrogate such as the S&P Industrials (formerly



the S&P 400). In particular, the Commission proposes using the S&P Industrials' average cost of capital as the fair rate of return for cable operators.

13. The Commission's proposal to use the S&P Industrials as a surrogate for the purpose of estimating the cable industry's average cost of capital would produce an excessive rate of return on equity for cable operators. While the typical firm in the S&P Industrials finances its investments with 60 percent equity and 40 percent debt, the typical cable operator finances its investments with at least 86 percent debt. Since equity has a higher required rate of return than debt, applying the average cost of capital for the S&P Industrials to the typical cable operator financing with at least 86 percent debt would produce a rate of return on equity for the cable operator far in excess of the range required to attract equity capital.

14. To illustrate the effect of the Commission's proposal, I have calculated the average cost of capital for the S&P Industrials and applied this average cost of capital to the average capital structure and cost of debt for the six large cable operators. As shown in Vander Weide Appendix 2, I estimate the S&P Industrials' average cost of capital to be 11.88 percent. Using the 14 percent equity and 86 percent debt figures for the large cable operators, I calculated that the large cable operators would earn a 36.93 percent rate of return on equity if they were allowed to earn an overall rate of return of 11.88

percent (see Appendix 3). The estimate of 36.93 percent is conservative because I used a capital structure which excluded the cable operators' large accumulated losses. Clearly, applying the S&P Industrials' average cost of capital to cable operators produces an excessive rate of return on equity for the cable operators.

- D. The Commission's proposal to use a 50/50 capital structure also produces an excessive rate of return on equity for cable operators.

15. The Commission also proposes using a 50/50 capital structure to set a fair rate of return for cable operators. This proposal would also produce an excessive rate of return on equity for many cable operators. As noted above, the typical cable operator has a capital structure containing 86 or more percent debt and 14 or less percent equity. Using a hypothetical 50/50 capital structure along with the cost of debt and cost of equity of the S&P Industrials produces an average cost of capital equal to 11.25 percent. Applying an 11.25 percent overall rate of return to the large cable operators' actual average capital structure of 86 percent debt and 14 percent equity, produces a 32.43 percent rate of return on equity (see Appendix 4). Again, this result is clearly an excessive rate of return on equity. Consequently, the Commission should set an overall fair rate of return using an average *actual* capital structure for the cable television industry, not a hypothetical 50/50 capital structure.

- E. The Commission should determine the cable operators' average cost of capital in the same way it determines the telecommunications companies' average cost of capital.**

**16. Rather than use the S&P Industrials as a surrogate, the Commission should determine the cable companies' average cost of capital in the same way it determines the telephone companies' average cost of capital:**

- a) Determine the actual average cost of debt of the industry's largest firms.**
- b) Estimate the cost of equity for the industry's largest firms using a surrogate if necessary.**
- c) Compute the overall rate of return using the actual average capital structure of the industry's largest firms.**

**The Commission should adopt the same approach for the cable industry as it has for the telecommunications industry. By using the cable industry's actual capital structure, the problems of accounting for the differences in financial structure between the surrogate and the cable companies are eliminated. The problems of excessively high rates of return on equity, as discussed in the preceding numerical example, are also eliminated.**

- F. The Commission should use the S&P Industrials as a surrogate in estimating the cable industry's cost of equity.**

**17. The cable industry's cost of equity cannot be estimated from cable industry data because most cable companies are either closely held, widely diversified, or pay no dividends. To estimate the cable industry's cost of equity, therefore, the Commission should identify a surrogate group of companies with overall risks similar to the risks of the cable industry. For the purpose of identifying surrogate firms, it is helpful to consider separately the two components of total investment risk: business risk and financial risk.**

**18. From a business risk perspective, cable companies are viewed as having very low risk. According to Standard & Poor's *Creditweek*, April 5, 1993, p. 51:**

**Industry risk remains low, relative to the average industrial company, due to the stability of service demand, continuing subscriber growth, and the predictability of cash-flow generation. Through the recession and slow recovery, a period of low consumer confidence, demand for cable TV service increased.**

**The industry's "stability of service demand" results because most communities have granted a franchise to only one company. The "continuing subscriber growth" results from technological changes that increase the capacity of the cable network to deliver services. Its "predictability of cash flow generation"**

results from its high market penetration, its resistance to recessionary forces, and its low maintenance cost once the system is built. Looking at the business risk side alone, the cable companies would be significantly less risky than the local telephone companies because they face significantly less competition. While the overwhelming majority of cable operators still face no multichannel competition in their local markets, telephone companies face rapidly increasing competition for their most profitable business — a trend that the Commission is actively promoting through its interconnection proceedings.

19. The cable operators' low business risk is partially offset by higher financial risk that results from their high reliance on debt financing.

According to Standard & Poor's *Creditweek*, February 24, 1992, p. 6:

Easy availability of debt financing through bank borrowings and high-yield debt markets enabled cable operators to acquire smaller players in a market characterized by rising cable system prices and cash flow multiples. Rising asset values and the liquidity of this market gave lenders confidence that, should borrowers experience financial difficulties, a few properties could be sold at a premium to pay down debt.

As a result of the easy debt financing and losses incurred during the early years of their business, many cable operators now have more than 100 percent debt in their capital structure (i.e., they have negative equity).

20. As long as the cable industry maintains its current high leverage policy, and as long as the Commission uses the cable industry's *actual capital structure* to set an overall rate of return, I recommend that the third quartile of the S&P Industrials (that quartile with the second highest DCF cost of equity) be used as an appropriate surrogate in determining the cable industry's cost of equity. While companies in the third quartile of the S&P Industrials have significantly greater business risk than the average cable operator, they also finance their investments with significantly more equity. Considering both business and financial risk, I believe that an equity investment in the third quartile of the S&P Industrials has approximately the same risk as an investment in the cable industry. At present, as determined by the DCF methodology the Commission applies to the telecommunications industry, the third quartile of the S&P Industrials has an average cost of equity equal to 15.11 percent.

21. In contrast, if the Commission fails to adopt the cable industry's *actual average capital structure* for purposes of estimating the cable industry's average cost of capital and, instead, decides to use a hypothetical capital structure such as 50 percent debt and 50 percent equity, then I believe the Commission should estimate the cable industry's cost of equity from the first quartile of the S&P Industrials (that quartile with the lowest DCF cost of equity). My recommendation to use the first quartile in this circumstance recognizes that the cable operators would have very low overall risk if their

capital structure were 50/50. The current average cost of equity of the first quartile of the S&P Industrials is 11.80 percent.

22. Regarding the Commission's request for comments on the use of the DCF and Risk Premium methodologies to estimate the cable industry's cost of equity capital, the Commission has studied this issue extensively with regard to the telecommunications companies and should apply the same methodologies to the cable companies as to the telecommunications companies.

- G. The Commission should reexamine the 10 to 14 percent rate of return range for cable operators.

23. The Commission tentatively concludes that a fair rate of return for cable operators is in the range 10 to 14 percent and seeks comments on how it can select a maximum rate of return within this range. The Commission's conclusion is based on its use of a 50/50 capital structure for the cable industry. Since the cable industry has a much higher degree of leverage than the Commission has assumed, the Commission should reexamine its 10 to 14 percent range for the cable operators. In fact, using an 86 percent debt and 14 percent equity capital structure, a cost of debt equal to 7.80 percent, and a cost of equity equal to 15.11 percent (the DCF result for the third quartile of the S&P Industrials), I estimate that the cable industry's fair rate of return is approximately 8.83 percent.

**24. The Commission also seems to think that it can choose a number within the 10 to 14 percent range based on its desired weighting of ratepayer and cable operator interests. As noted above, the capital attraction standard already provides an appropriate balancing of ratepayer and operator interests. The Commission should set the cable operators' fair rate of return equal to the cable industry's average cost of capital, not arbitrarily choose a rate of return from within a wide range because of a desire to balance ratepayer and operator interests.**

**H. A Single Rate of Return is the Only Practical Approach for Setting Rates.**

**25. As the Commission has tentatively concluded, establishing a single rate of return for all cable operators is the only practical approach for setting rates in a cost of service showing. The alternative of establishing separate rates of return for each cable operator or each cable franchise would be costly to administer, and whatever limited economic benefits might be derived, would be unlikely to justify the administrative costs required. This approach is also consistent with the Commission's efforts, and the urging of the cable industry, to streamline its cost of service rules where possible.**



### **III. RATE BASE AND ALLOWED EXPENSES**

- A. Net Original cost is the best alternative for valuing cable operators' plant in service.**

**26. As the Commission notes, the value of plant in service will be a major component of the cable operators' revenue requirements under cost of service regulation. The Commission offers four alternative approaches to determining the value of a cable operator's plant in service: market value, original cost, replacement cost, and reproduction cost. Original cost, net of depreciation, is the standard used by the Commission in its regulation of telecommunications companies, and the Commission is correct in its conclusion that net original cost is the best alternative for cable companies as well.**

**27. As a method of valuing plant in service, market value is flawed by its inherent circularity. The market value of a regulated firm's assets depends on the market's expectations of the future cash flows generated by those assets, but the regulated firm's cash flows themselves are determined by regulators. Thus, market value in a regulated environment is the result of regulation rather than the starting point. Furthermore, market values prior to October 1992 should not be used either. Those values were based on the expectations of continued monopoly profits which Congress has directed the**